IN THE

Supreme Court of the United States

OCTOBER TERM, 1950.

No. 461

IN THE MATTER OF
FEDERAL FACILITIES REALTY TRUST, A COMMON LAW TRUST, AND NATIONAL REALTY TRUST, A COMMON LAW TRUST,

Debtors.

STACY C. MOSSER, SUCCESSOR TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST, AND JOHN W. GUILD, INDENTURE TRUSTEE, ETC.,

Petitioners,

vs.

PAUL E. DARROW, FORMER TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST,

Respondent.

REPLY OF PETITIONERS TO REPLY BRIEF OF RESPONDENT DARROW.

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Respondent.

REPLY BRIEF OF PETITIONERS TO BRIEF OF PAUL E. DARROW, RESPONDENT.

In order to place certain of the allegations of fact set forth by Respondent Darrow in his brief in correct perspective and to point out some of the respects in which Darrow's brief avoids primary questions in this case, petitioners are filing this reply.

Respondent Darrow asserts, in defense to the surcharge for breach of fiduciary duty, that the estate enhanced

in value and indebtedness of the various subsidiaries was reduced during the eight years of his trusteeship. The bulk of the securities purchased or retired during his administration were purchased through sinking funds created by the subsidiaries pursuant to plans of reorganization. The trustee was under a duty to carry out this program, and it was for carrying out his duties, which included this activity, that he received compensation. The enhancement in value was attributable to general economic conditions.

The allegations on pages 2 and 3 of Respondent's brief concerning profits allegedly made during the period of Darrow's trusteeship, are not responsive to the question of the breach of fiduciary duty raised by these proceedings. A trustee should make purchases as cheaply as possible without permitting his employees to make profits in connection with such transactions. The fact that certain securities purchased by the trust subsequently increased in value does not exculpate the trustee for liability in connection with their acquisition. Respondent proposes a novel and pernicious doctrine to the effect that surcharging a trustee should depend upon a mathematical relation between the amount of alleged "profits" during the trustee's administration as contrasted with the amount of improper gains which the trustee permitted and assisted his employees to exact. The law requires strict observance of fiduciary standards on the part of trustees; to do as Respondent contends, namely, to offset alleged profits against the amount of prohibited gains, would be a sharp break with existing law and a serious undermining of trust administration. This court should make it clear by its decision in this case that no such doctrine of mathematical equations will be tolerated and that a trustee must observe the highest standards of fiduciary duty without knowingly permitting diversion from the trust of any assets or benefits at all.

In these proceedings Darrow remained in office for over eight years without filing any report or account in the Federal Facilities Realty Trust proceedings and only filing one account in the National Realty Trust proceedings (R. 546); he never sought or received approval by order of court for the securities transactions involving Jacob Kulp and Myrtle Johnson or his condonation thereof or participation therein; he did not disclose to anyone, including his attorney, the fact that his key employees were trafficking in the securities of the trust with his permission and assistance (R. 512).

Respondent's brief states (p. 40) that Darrow first learned of any complaint against his administration when the director of the SEC called him to his office. Darrow of course knew that an order had been entered in 1942 directing the appointment of Andrews, a certified public accountant, to investigate the two trusts (R. 350). This appointment had been made on the prayer of a petition filed in the cause raising serious questions concerning his administration. Since the Andrews report provided much of the information on the basis of which a surcharge was imposed upon Darrow, it seems somewhat cavalier to say, as the Respondent does (Res. Br. 9) that there is nothing in the Andrews report which caused Darrow to resign as trustee nor is there anything in that report reflecting on his loyalty to the trusts or his accounts.

Attention must be called to the fact that Darrow claims credit for so-called "profit" in connection with a portion of the Seligman transaction (Res. Br. 64). This whole transaction is described on pages 7 and 8 of petitioners' original brief and will not be repeated at length here. It must be pointed out here, however, that certain bonds of the subsidiaries, constituting a portion of the securities in Lot I purchased at the Seligman sale, were resold by Miss

Johnson to Darrow for $12,447, although the cost to Miss Johnson of all the securities in that lot was approximately $8,000; moreover, Darrow paid trust funds in advance of delivery for these securities, as was his custom (R. 519), to finance the transaction for Miss Johnson. Furthermore, additional bonds of subsidiaries procured in the purchase of Lot I were sold to customers of Colonial who subsequently resold them to Darrow (R. 522). As a result of this transaction for which Darrow claims special consideration, Miss Johnson realized from the securities in Lot I a total of $34,905, or $10,701 more than was paid for both Lots I and II; Lot II, which she and Jacob Kulp now claim to own in other proceedings pending below, consists of $286,100 principal amount of Federal bond, 62,358 units of beneficial interest of Federal representing over 60% of the equity in Federal and 10,761 units of National representing about 25% of the equity in National, and Lot II probably represents control in the reorganizations of both trusts (R. 517-21, 556-7). The conduct of Darrow in connection with the Seligman transaction was improper and petitioners are astonished that any part of such a transaction should even be suggested as a basis for credit to the trustee. This creates a reaction somewhat similar to that caused by the following statement made by Darrow (R. 341):

> "It was my opinion that I had a right to deal in these securities, selling them either to the trusts or subsidiaries and earn a profit. (I (personally) didn't do any trading out of consideration for Judge Holly and my father.) I realized it would be dangerous practice because somebody would try to show that I had been unreasonable in my dealings with the trusts. * * *. I considered it appropriate to permit Miss Johnson, Kulp or Colonial to trade in the bonds of the subsidiaries for a profit. * * * Whether the profit they realized in transactions with me was reasonable

or not was of no consequence to me. The important thing was that I did not pay them more than I was paying anybody else."

Another item for which Darrow claims credit (Res. Br. 3-4) is the acquisition of Federal bonds of the par value of $84,000. These securities were acquired in 1937 when Darrow paid $12,000 to Colonial Securities Company (a securities company operated and controlled entirely by Myrtle Johnson and Jacob Kulp, described more fully on page 5 of petitioners' brief herein) which money Colonial used to purchase from the First National Bank of Chicago a note for $27,300 (guaranteed by Jacob Kulp individually) together with the collateral for such note, namely, certain subsidiary bonds with a total par value of $33,000, bonds of Federal with a total par value of $84,000, and a non-negotiable receipt of National City Bank of Cleveland. Colonial took Darrow's $12,000, made this purchase from the bank and then sold to Darrow for $12,000 the bonds of the subsidiaries. Colonial retained the deposit receipt and also the note guaranteed by Jacob Kulp, thus making a profit for Colonial and releasing Kulp from obligation under a note guaranteed by him, all through the use of trust funds advanced by Darrow. The $84,000 of Federal bonds were handled in a highly unusual fashion. They were then "given" to Darrow by Miss Johnson on behalf of Colonial without cost; their existence was publicly revealed for the first time during interrogation at the hearing before the Special Master on July 11, 1946, almost ten years after they had been acquired. These bonds had not been disclosed in any of Darrow's accounts nor in the accompanying schedules, nor had they been turned over to Darrow's successor despite an order almost three years earlier requiring Darrow to make a complete turn-over of all the securities of the trust. Darrow had, however, on December 9, 1943 filed an affidavit in the

proceedings—without notice to parties of record—setting forth the acquisition of these securities, stating that the bonds were received free of cost and that their disposition seemed to be a matter for the direction of the court. The affidavit further stated that Darrow's intention had been eventually to deliver the bonds to Federal. This transaction, however, is certainly not one for which Darrow can claim any credit (R. 540-43).

Respondent also alleges, on page 40 of his brief, that 27 subsidiaries of the two trusts were successfully reorganized and put on their feet by Darrow's management. It should be noted in passing that a large number of these subsidiaries are now in process of reorganization for the second time. Another matter which should be considered in connection therewith is the following transaction in which the Special Master found Darrow "deserving of censure" (R. 558). Darrow advanced $750 from the trust to permit Miss Johnson to purchase a large number of assets in the bankruptcy sale of Jacob Kulp & Company for $1,500. Miss Johnson then sold to Darrow certain books and records of Jacob Kulp & Company (which already were in Darrow's possession) for $750, leaving Miss Johnson certain securities which she sold for about $350 and also leaving her with certain alleged accounts receivable of Jacob Kulp & Company of disputed and doubtful validity against the trust's various subsidiaries and one other company, in the aggregate amount of $172,436.47, which she then assigned to Mr. Bauman, the son-in-law of Jacob Kulp. Darrow while trustee and president of various subsidiaries filed no objection to the allowance of certain of these accounts receivable to the extent of $81,311.34 in reorganization plans of six of the subsidiaries (R. 534-8). The Special Master found (R. 538):

> "It should be noted, however, that Miss Johnson participated in most, if not all, of these reorganiza-

tions. At this time it appears that she and Kulp, by virtue of an understanding with Bauman, had an interest in the accounts receivable, for they were to share in them, when and if Bauman's loans were repaid."

The Special Master further found that (R. 552):

"Of course, no attempt is made in these hearings to consider the fairness of these plans of reorganization of the subsidiaries, but it should be noted that Miss Johnson participated in reorganizations where the claims of Jacob Kulp & Company (then held by Bauman) were set up. She admitted she knew these accounts receivable were set up. She admitted she knew these accounts receivable arose from advances of commingled funds. She said, however, she never discussed their origin with Darrow and never suggested that objections might be filed to these claims. It must also be borne in mind that during this period Miss Johnson and Colonial were purchasing bonds from bondholders and reselling them to Darrow at a profit—sometimes on the same day."

The argument on pages 12-37 of Respondent's brief relies primarily on the inapplicable cases cited below, which are considered by Respondent at great length.[1] None of of these cases is applicable to the present situation. In each of these cases the fiduciary was held not subject to surcharge because the alleged improper action was neither known to him nor could have been known to him in the exercise of reasonable diligence. All of these cases indicated that, if the trustee had been informed of the actions criticized or were guilty of supine negligence or were at fault, an entirely different situation would have existed. Trustee

1. *Willoughby* v. *Howard*, 302 U. S. 445; *Taylor* v. *Benham*, 5 How. 233; *Osgood* v. *Franklin*, 2 Johnson's Ch. 27; *Ellig* v. *Naglee*, 9 Calif. 684; *In re Marcus*, 67 F. (2) 1008; *In re Portex*, 43 Fed. Supp. 859; *Evans* v. *Williams*, 276 F. 650; *Ex Parte Belchier*, 1 Amb. 218; *Speight* v. *Gaunt*, 9 A. C. 1, and *In re Vickery*, 1 Ch. 572.

Darrow was guilty of supine negligence and was at fault in the most flagrant way. He knew fully of his employees' trafficking in securities of the trust; he knew they were making profits and he continued his dealings with them. All of these cases stressed by Respondent are therefore inapplicable here.

Respondent also relies upon the case of *Semans* v. *United Lumber Company*, 281 Pa. 404; 126 Atl. 776 for the proposition that a trustee who has performed acts "in good faith" will not be surcharged. The facts in that case are very different from the factual situation here presented. The ineptitude manifested by Darrow and his failure to use proper efforts to effect purchases of securities at the lowest possible price distinguish this case sharply from the situation in the *Semans* case and make it evident that the trustee is not acting in the "good faith" which the *Semans* case contemplates. If any other interpretation were given to the *Semans* case it would be contrary to the doctrine of *Magruder* v. *Drury*, 235 U. S. 106, and to the general line of federal authority with respect to a trustee's inability to deal with his estate. See, *In re Real Estate Mortgage Guaranty Co.*, 55 Fed. Supp. 749.

Respondent also relies strongly (Res. Br. 20-23) upon the case of *SEC* v. *Chenery Corp.*, 318 U. S. 80 (1943) and states that this court has rejected the so-called "stern rule" of fiduciary responsibility. It is unnecessary to call this court's attention to the fact that this court decided the second *Chenery* case in *SEC* v. *Chenery Corp.*, 332 U. S. 194 in which this court sustained the commission's order requiring preferred stock acquired by management interests to be surrendered at cost plus dividends. This court stated in the second *Chenery* case, quoting the first *Chenery* case:

"Abuse of corporate position, influence, and access

> to information may raise questions so subtle that the law can deal with them effectively only by prohibitions not concerned with the fairness of a particular transaction."

This court, in the second *Chenery* case, as in numerous other cases which were cited in petitioners' brief, has rejected the rule of laxity which Respondent calls a "liberal policy." As was stated by this court in the first *Chenery* case:

> "We reject a lax view of fiduciary obligations and insist upon their scrupulous observance."

Respondent reiterates in his brief the assertion that there has been no loss to these estates and even asserts that these petitioners do not contend that the estates suffered any loss. Respondent's brief states, page 38:

> "Petitioners do not argue that there were any losses. On the contrary they tacitly admit (Br. 25) these Estates 'suffered no loss in the transactions involved.'"

The actual quotation from petitioners' brief which Respondent has eviscerated said:

> "Even if the estate suffered no loss in the transactions involved, which the Special Master found was not the case (R. 554), that fact still would not insulate from liability a trustee who had been derelict in his fiduciary duty."

These estates did suffer financial loss and are seeking recoupment of moneys to which they are entitled and compensation for injuries inflicted upon them. Among other things, they were deprived of the right to purchase securities at lower prices; they were deprived of opportunities to make advantageous purchases, and they were deprived of the profits made by the trustee's employees; they were deprived of the undivided loyalty of their fiduciaries. Al-

though petitioners are pointing out these losses, petitioners wish to make it clear that they believe the law is unequivocal to the effect that a trustee is liable for a breach of duty regardless of whether any loss is inflicted upon his estate.

Respondent asserts on page 9 of his brief and elsewhere that the bonds of Federal will be paid in full. There is no assurance whatsoever of that fact and there is no supporting evidence in the record cited to that effect. This is pure conjecture. However, even if this were the fact, which is certainly not admitted, the trust must enforce all of its rights for the benefit of the participation certificates a large part of which were distributed to the public.

Respondent cites *National Labor Relations Board* v. *Pennsylvania Steamship Co.*, 95 L. Ed. 318, decided February 26, 1951 for the proposition that the Court of Appeals is not in error for upsetting concurrent findings of fact by the Special Master and the District Judge without determination that these findings were clearly erroneous. It should be noted that the *Pennsylvania Steamship Co.* case involved direct review by the Court of Appeals of a finding of the National Labor Relations Board; there was no determination of fact by a district court. Consequently, the *Pennsylvania Steamship Co.* decision, if analogous to the present situation, supports the proposition for which petitioners contend, namely, that a finding by the first fact finding agency, concurred in by the court which reviews it, should not be overturned on appeal therefrom unless clearly erroneous.

Conclusion.

Respondent devotes most of his brief to interpretations concerning the common law with respect to surcharges, but Respondent does not advert at all to the authoritative statement of common law set forth in the Restatement of the Law of Trusts. The Restatement in Sec. 225, Vol. 1, p. 639, which is directly applicable to the present factual situation says, among other things, that a trustee is liable for acts of his agent which, if done by the trustee, would constitute a breach of trust, if the trustee either directs or permits the act of the agent or approves or acquiesces in or conceals the act of the agent or neglects to take proper steps to compel the agent to redress the wrong. Respondent Darrows' conduct falls within all of these prohibited categories for which liability is imposed.

We respectfully submit that this court should reverse the decision of the Court of Appeals for the Seventh Circuit in this case and sustain the surcharge imposed by the District Court.

Respectfully submitted,

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